CalPERS
Investment Office
P.O. Box 2749
Sacramento, CA 95812-2749
Telecommunications Device for the Deaf - (916) 795-3240
(916) 795-3400

June 16, 2008

AGENDA ITEM 8a

TO: MEMBERS OF THE INVESTMENT COMMITTEE

I. SUBJECT: Manager Development Program (MDP) I and II Annual Review

II. PROGRAM: Global Equity

III. RECOMMENDATION: Information only

IV. ANALYSIS:

Executive Summary

This agenda item provides an update on CalPERS' Manager Development Program (MDP) and is comprised of a review of the MDP investment portfolio performance and venture capital portfolio performance. An opinion letter from Wilshire Associates is shown in Attachment 1.

The MDP is a unique program in which CalPERS, through its MDP partners, provides venture capital to emerging public markets investment managers in return for a minority equity stake, and also provides funds for the emerging firms to manage. CalPERS' current MDP partners will be available to answer questions at the June 16, 2008 Investment Committee meeting.

The investment concept behind MDP is that the venture returns from CalPERS' equity stake will boost the returns achieved from the investment portfolios. MDP is a way of investing with emerging managers that strives to provide the means for existing emerging firms to be successful. Uniquely, the program also has the potential to create brand new emerging firms. Two of the eleven firms currently in the MDP were pure start-ups who received their initial funding from CalPERS, while four had less than $250 million in assets under management at the time of CalPERS' funding.

MDP I

The MDP consists of two programs: MDP I and MDP II. MDP I began in June 2000 with two partners: Progress Lovell Minnick and Strategic Investment Management. MDP I has the following features:

- A commitment of $40 million in venture capital to each partner with fees paid on committed capital
- A commitment of $2 billion in investment assets to Strategic Investment Management and $1 billion in investment assets to Progress Lovell Minnick
- Each MDP partner has full discretion on investments made
- A fixed investment period of three years (which was extended six months)
- An overall term of seven years, with the option of five one-year extensions

In May 2008, MDP I started its second one-year extension. As there are no new investments being made in MDP I, the role of the MDP I partners at this point of the program is to:

- Monitor the portfolio performance
- Assist and develop the MDP I firms
- Negotiate the exit strategies for the private equity investments

During the investment period of MDP I, Progress Lovell Minnick allocated $850 million in investment assets among eight firms. Four firms have been terminated, one exited the program due to an organizational change, and one firm was transitioned to the mainstream external equity program, while continuing to manage a small portfolio in MDP I. MDP managers, who transition to the mainstream program may, at CalPERS' discretion, continue to manage MDP assets as long as CalPERS has ties to the manager on the venture capital side, including potential receipt of contingency payments. Strategic Investment Management allocated $1.7 billion in investment assets among eight firms. Two firms have been terminated and one firm was transitioned to the mainstream external equity program.

Since its inception in 2000, the MDP I program has experienced mixed performance results. While the private equity portion of the program has exceeded staff's expectations, the investment portion has had less favorable results. The changes made for MDP II were designed to address this performance issue and to better align interests between CalPERS and its partners.

<u>MDP II</u>

At the August 18, 2003 Investment Committee meeting, staff presented ideas from staff and Wilshire Associates to improve the MDP. At its August 16, 2004 meeting, the Investment Committee approved and delegated authority to staff to expand and improve the MDP with the creation of MDP II, which has the following features:

- MDP II Partner management fees are paid on invested capital rather than on committed capital
- No specific commitment of CalPERS' capital or investment assets
- Both staff and the MDP II Partner must agree on each investment
- An open-ended, opportunistic investment period rather than a fixed term investment period

MDP II began in March 2007. There are two partners in MDP II: Legato Capital Management and Strategic Investment Management. Negotiations are ongoing with a potential third partner for MDP II.

Since its inception in 2007, three managers have been funded in MDP II. CalPERS and its partners continue to look at additional opportunities on an ongoing basis. Two opportunities are in final due diligence at this time. Attachment 2 provides additional background information on MDP I and II.

Emerging Manager Fund of Funds Program

In addition to the MDP, CalPERS also invests in emerging managers through its fund-of-funds program approved by the Investment Committee at its February 2007 meeting. A spring-fed pool of fund-of-funds managers was approved by the Investment Committee at its August 2007 meeting. FIS was funded $150 million in February 2008 and Leading Edge Investment Advisors was funded $150 million in March 2008. An emerging manager fund-of-funds program was seen as a desirable complement to the MDP as a way to access emerging managers and improve diversity in CalPERS' external manager lineup, while providing greater flexibility, given that a higher hurdle rate has been set for MDP II than MDP I in an attempt to improve performance. A separate annual review of this program will be provided to the Investment Committee in early 2009 when the program has a one year performance history.

Investment Portfolio Performance

Table 1 below summarizes the amount of investment assets and the number of managers by MDP partner as of April 30, 2008.

Table 1 – Assets and Managers by Partner as of April 30, 2008

MDP Partner	Investment Assets as of April 30, 3008	Number of Managers
MDP I:		
Progress Lovell Minnick	$539 million	3
Strategic Investment Management	$1,036 million	5
MDP II:		
Legato Capital Management	$411 million	2
Strategic Investment Management	$153 million	1

Table 2 below provides investment performance by partner. Returns for individual managers are shown in Attachment 3. Graphs of individual manager's performance are presented in Attachment 4.

Table 2 – Performance and Information Ratio as of April 30, 2008

MDP Partner	AUM 4/30/08 (MM)	1 Year	3 Years	5 Years	Annualized Since Inception [1]	Inception Date	3 Year Info. Ratio
Progress Lovell Minnick	$538.6	-3.84%	11.94%	13.61%	1.16%	6/1/00	-0.17
Benchmark		-2.37%	12.30%	15.19%	3.66%		
Excess Return		*-1.47%*	*-0.36%*	*-1.58%*	*-2.50%*		
Progress + Trans. Firm	***$1,613.1***	***1.34%***	***17.77%***	***19.11%***	***4.14%***	***6/1/00***	***0.35***
Benchmark		***1.99%***	***16.95%***	***19.44%***	***5.96%***		
Excess Return		***-0.65%***	***0.82%***	***-0.33%***	***-1.82%***		
Strategic (MDP I)	$1,035.8	-0.21%	10.09%	12.76%	6.54%	1/1/01	-0.88
Benchmark		-0.70%	11.23%	14.09%	6.23%		
Excess Return		*0.49%*	*-1.14%*	*-1.33%*	*0.31%*		
Strategic + Trans. Firm	***$1,531.9***	***-2.16%***	***9.52%***	***12.41%***	***6.31%***	***1/1/01***	***-0.93***
Benchmark		***-2.44%***	***10.64%***	***13.73%***	***6.01%***		
Excess Return		***0.28%***	***-1.12%***	***-1.32%***	***0.30%***		
Total MDP I	$1,574.4	-1.43%	10.45%	12.96%	2.25%	6/1/00	-0.94
Benchmark		-1.16%	11.48%	14.46%	3.96%		
Excess Return		-0.27%	-1.03%	-1.50%	-1.71%		
Total MDP I + Trans. Firms	***$3,145.0***	***-0.45%***	***13.21%***	***15.46%***	***3.63%***	***6/1/00***	***-0.23***
Benchmark		***-0.23%***	***13.50%***	***16.37%***	***4.80%***		
Excess Return		***-0.22%***	***-0.29%***	***-0.91%***	***-1.17%***		
Legato Capital Mgmt.	$411.3	-5.16%	-----	-----	0.31%	3/1/07	-----
Benchmark		-3.74%	-----	-----	1.46%		
Excess Return		*-1.42%*	-----	-----	*-1.15%*		
Strategic (MDP II)	$153.4	-----	-----	-----	3.52%	3/1/08	-----
Benchmark		-----	-----	-----	4.52%		
Excess Return		-----	-----	-----	*-1.00%*		
Total MDP II	$564.7	-5.52%	-----	-----	-0.02%	3/1/07	-----
Benchmark		-3.74%	-----	-----	1.46%		
Excess Return		*-1.78%*	-----	-----	*-1.48%*		
MDP I & II Combined	$2,139.1	-1.84%	10.30%	12.87%	2.20%	6/1/00	-----
Benchmark		-0.76%	11.63%	14.55%	4.01%		
Excess Return		*-1.08%*	*-1.33%*	*-1.68%*	*-1.81%*		
MDP I & II + Trans. Firms	***$3,709.7***	***-0.74%***	***13.00%***	***15.46%***	***3.62%***	***6/1/00***	***-----***
Benchmark		***-0.17%***	***13.45%***	***16.34%***	***5.00%***		
Excess Return		***-0.57%***	***-0.45%***	***-088%***	***-1.38%***		

The performance objective of the MDP partners is to outperform their aggregate custom benchmark. The partners' custom benchmarks are a weighted average benchmark of the underlying managers' benchmarks for each of the products in the partners' portfolio.

One Year Investment Performance Commentary

As shown in Table 3 below, for the 12 months ending April 30, 2008, the Progress portfolio underperformed its custom benchmark by 1.47% and the Strategic portfolio outperformed its custom benchmark by 0.49%. These returns, shown in bold font, are net of manager fees, *include* the returns of one manager in the Strategic program whose investment portfolio was terminated due to poor performance in November 2007, and *exclude* the returns from the venture capital investments. The table also shows the returns if the two managers transitioned to CalPERS' mainstream program are included.

There are three managers left in the Progress portfolio and all underperformed for the year ending April 30, 2008. Of these three managers, one has excellent long-term performance, outperforming from inception by over by 2.37% annually, while the other two trail their benchmark from inception by 71 and 89 basis points annually. All three managers employ a quantitative strategy and the past year was particularly difficult for quantitative active management. As shown in Table 3 below, Progress' return for the year improves, but still lags the benchmark, with the inclusion of the manager that transitioned from the Progress portfolio to the mainstream external equity program.

The Strategic portfolio return reflects the results of five managers running six portfolios, plus the returns of a manager terminated in November 2007. Of the remaining manager portfolios, three outperformed, one was almost flat, and two underperformed. The return for the year is lower when the manager that transitioned from the Strategic portfolio is included. The transitioned manager has excellent long-term performance but its quantitative strategy struggled a bit over the last year. Finally, the last line of Table 3 shows the return achieved for the managers currently in the Strategic portfolio. This reveals the impact of the manager that was terminated in November 2007 on the overall one year results of the Strategic portfolio.

Within MDP I, the aggregate of the seven domestic equity managers from both programs outperformed their composite benchmark by 0.72%. However, the three international managers, one of which was terminated in November 2007, underperformed their composite benchmark by 1.99%.

As noted above, details on individual manager performance is shown in Attachments 3 and 4.

Table 3 – One Year Returns for MDP I

Year Ending April 30, 2008	Composite Return	Benchmark Return	Excess Return
Progress Lovell Minnick	**-3.84%**	**-2.37%**	**-1.47%**
Progress + Transitioned Firms	1.34%	1.99%	-0.65%
Strategic Investment Management	**-0.21%**	**-0.70%**	**0.49%**
Strategic + Transitioned Firms	-2.16%	-2.44%	0.28%
Current Strategic Managers Only	0.62%	-0.99%	1.61%

MDP II is in its early stages. As of April 30, 2008, MDP II consisted of one manager with a 14 month performance history, one manager with a two-month performance history, and one manager running two portfolios, both with a one-month performance history. Two of the three managers in MDP II use quantitative strategies which have struggled over the last year. Results are shown in Table 4 below.

Table 4 – One Year Returns for MDP II

Year Ending April 30, 2008	Composite Return	Benchmark Return	Excess Return
Legato Capital Management	-5.16%	-3.74%	-1.42%
Strategic Investment Management[1]	3.90%	4.86%	-0.96%

[1]*Returns for Strategic Investment Management are two month returns.*

<u>From Inception Investment Performance Commentary</u>

As shown in Table 5 below, the Progress portfolio underperformed its benchmark by 2.50% and the Strategic portfolio outperformed its benchmark by 0.31%, on an annualized basis, from inception through April 30, 2008. These returns, shown in bold font, are net of manager fees, *include* the performance of managers who have been terminated from the MDP I program, and *exclude* the returns from the venture capital investments. If the two managers that have transitioned to CalPERS' mainstream external equity program are included, the Progress portfolio's from inception year excess return is -1.82, and Strategic's from inception excess return is 0.30%. The returns of only those managers in the program as of April 30, 2008 (excluding terminated and transitioned managers) show a positive excess return of 77 basis points for the Progress portfolio and a positive excess return of 13 basis points for the Strategic portfolio.

Because the investment period is closed for MDP I, when managers transition from the MDP I program, additional managers cannot be added. As such, a larger percentage of the program is now allocated to the remaining managers in the program. This results in a more concentrated portfolio with a greater percentage of start-up firms that are in an earlier stage of development. MDP II was created with an open investment period, allowing additional managers to be added on an opportunistic basis.

Table 5 – From Inception Returns for MDP I

Year Ending April 30, 2008	Composite Return	Benchmark Return	Excess Return	Inception Date
Progress Lovell Minnick	**1.16%**	**3.66%**	**-2.50%**	**6/1/00**
Progress + Transitioned Firms	4.14%	5.96%	-1.82%	
Current Managers Only	6.37%	5.60%	0.77%	
Strategic Investment Mgmt.	**6.54%**	**6.23%**	**0.31%**	**1/1/01**
Strategic + Transitioned Firms	6.31%	6.01%	0.30%	
Current Managers Only	9.48%	9.35%	0.13%	

As noted above, MDP II is in its early stages. The Legato portfolio shown below consists of one manager with a 14 month performance history and one manager with a two-month performance history. Given the short history during a difficult environment for active management, it is too early to comment on results. Performance for the Strategic MDP II portfolio, which has a two month history, is shown in Table 4 above.

Table 6 – From Inception Returns for MDP II

Year Ending April 30, 2008	Composite Return	Benchmark Return	Excess Return	Inception Date
Legato Capital Management	0.31%	1.46%	-1.15%	3/1/07

Attachment 5 provides risk/returns charts for the MDP I managers' portfolios. There is not sufficient history to provide these charts for the Strategic MDP II portfolio.

Venture Portfolio Performance

The private equity portfolio performance for each MDP I partner is shown in Table 7. The MDP II program is too new to provide meaningful data.

Table 7 – Private Equity Portfolio

MDP I Partner	$ Amount Invested	$ Amount Distributed	Valuation[1]	Multiple of Cost	Net IRR[2]
Progress Lovell Minnick	$22.2 mil	$81.8 mil	$86.7 mil	3.0X	24.2%
Strategic Investment Mgmt. (MDP 1)	$ 9.3 mil	$63.9 mil	$72.0 mil	7.8x	40.1%

[1]Valuation represents unrealized values plus any distributions received. Please note that valuations are based on trailing financial performance and are contain estimates. However, realized valuations are audited by an independent outside party. **[2]** *Performance is net of MDP partner management fees and carried interest.*

The private equity performance results are favorable. CalPERS has realized five investments at a gross IRR return in excess of 20%. In addition, CalPERS has recouped all of its capital contributions and management fees from both realized investments and ongoing cash distributions.

Growth in assets under management for the firms remaining in MDP is shown in Attachment 6.

V. STRATEGIC PLAN:

This item is consistent with the Strategic Plan: Goal VIII, manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and, second, to minimize and stabilize employer contributions.

VI. RESULTS/COSTS:

The purpose of this item is to keep the Investment Committee informed of the progress and performance of the Manager Development Programs I and II.

LaShae Howell
Investment Officer I

Melissa Paminto
Investment Officer II

Mary C. Cottrill
Senior Portfolio Manager

Eric Baggesen
Interim Senior Investment Officer

Anne Stausboll
Interim Chief Investment Officer